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No. 85-519

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

—v.—

B. J. LOFTSGAARDEN; ALOTEL, INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

In an action under the federal securities laws for fraud committed in the sale of shares in a tax-shelter investment, should the plaintiffs' recovery be reduced by tax benefits realized from the investment?

TABLE OF CONTENTS

	PAGE
STATEMENT OF THE CASE	1
SUMMARY OF THE ARGUMENT	7
ARGUMENT	9
I. Tax Benefits Created And Distributed By Tax Shelters Are A Return On An Investment	9
II. Damage Awards Under The Securities Laws Are Reduced By Returns On The Investment, Including Tax Benefits From Tax Shelters	15
A. Tax Benefits Must Be Subtracted Under Rule 10b-5	15
B. The Collateral Source Rule Does Not Apply	21
C. Tax Benefits Must Be Subtracted Under Section 12(2)	25
1. Section 12(2) Must Be Read *In Pari Materia* With Rule 10b-5	25
2. Regardless Of *In Pari Materia* Concepts, Tax Benefits Must Be Subtracted In Rescission And Restitution Under Section 12(2)	27
D. Interest Was Properly Awarded Only On The Amount The Petitioners Were Out Of Pocket At Any Given Time	30
III. This Court Should Correct The Eighth Circuit's Plain Error Of Doubling The Petitioners' Entire Recovery	32

PAGE

IV. Other Points Raised By The Petitioners And The Amici 34

A. Alleged Inconsistency With Supreme Court Precedent 34

B. The Petitioners Will Not Have To Amend Their Returns 35

C. Deterrence Of Disclosure Violations 37

D. "Banking A Fraud" 39

E. Different Damage Awards Based On Actual Injury 40

F. "Speculativeness" Of The Petitioners' Tax Consequences 40

G. Unjust Enrichment 42

CONCLUSION 44

TABLE OF AUTHORITIES

Cases: PAGE

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 16, 42

Alfred Bell & Co. v. Catalda Fine Arts, Inc., 191 F.2d 99 (2d Cir. 1951) 20

Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975) 37

Austin v. Loftsgaarden ("Austin I"), 675 F.2d 168 (8th Cir. 1982) ..... *passim*

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Beggs v. Dougherty Overseas, Inc., 287 F.2d 80 (2nd Cir. 1961) 22, 38

Berg v. Xerxes-Southdale Office Bldg. Co., 290 N.W.2d 612 (Minn. 1980) 14

Berger v. Bishop Inv. Corp., 695 F.2d 302 (8th Cir. 1982) 26

Birdsall v. Coolidge, 93 U.S. 64 (1876) 19

Blau v. Lehman, 368 U.S. 403 (1962) 32, 38

Bridgen v. Scott, 456 F. Supp. 1048 (S.D. Tex. 1978) ... 14

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PAGE

Cant v. A.G. Becker & Co., Inc., 384 F. Supp. 814 (N.D. Ill. 1974) 31

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PAGE

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Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) ... 26

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PAGE

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Palmer v. Connecticut Ry. Co., 311 U.S. 544 (1941) ... 41

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Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) 38

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Sharp v. Coopers & Lybrand, 649 F.2d 175 (3rd Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).....13, 22, 38

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PAGE

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§ 46..... 9
§ 167..... 10
§ 168..... 12
§ 382..... 12
§ 465..... 39

PAGE

§ 701 *et seq*. 12
§ 702 21
§ 6065 41

Treas. Reg. § 1.704-1(b)(2)(iv)(b) (1985) 30

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§ 10, 15 U.S.C § 78*j* 5, 6, 26
§ 16, 15 U.S.C § 78*p* 32, 38
§ 17, 15 U.S.C § 78*q* 38-39
§ 20, 15 U.S.C § 78*t*. 26
§ 28, 15 U.S.C § 78*bb*. . . . . *passim*
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PAGE

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STATEMENT OF THE CASE

If it were possible to turn back the clock to 1973, and permit the petitioners truly to rescind their purchases against the respondents, the petitioners would turn over their partnership shares to the respondents, would get back their purchase price from the respondents, and would never receive tax benefits. The respondents would thereby acquire the shares and become entitled to the associated tax benefits.

The clock cannot be turned back. But the economic equivalent of turning it back can be attained, and was attained by the Eighth Circuit. The petitioners, who received in permanent tax benefits nearly as much as they invested, were awarded the difference.

Having been made whole, the petitioners now seek a measure of damages that would allow them to recover their investment in its entirety and keep all their tax benefits as well. Nothing in the securities laws permits this. The petitioners do not seek to remedy an injustice, but to create one. They seek a windfall for themselves and a penalty or forfeiture for the respondents.

The Petitioners' Investment

In 1973, the petitioners each decided to invest in a tax shelter, Alotel Associates, requiring that they have a net worth in excess of $200,000 or be in the 50% income tax bracket. (J.A. 157; P1. Ex. 2; Tr. 42). Each petitioner bought one "unit," or limited partnership share, for $35,000 except Dr. Neumann, who bought 1 1/2 units for $52,500. (J.A. 16, 35, 36). Alotel Associates was to apply the funds raised from the sale of these units, and from other sources, to build a Ramada Inn motel and to yield substantial tax benefits to the investors.

As with any tax shelter, tax benefits were a central consideration in the marketing and sale of the units. For example, as it

was originally marketed, Alotel Associates offered fewer tax benefits; in that form, it was unable to sell enough units to proceed (Tr. 109-11, 273, 647-48); a revised version of its program, for the same motel, but with enhanced tax benefits, had to be developed before enough investors were interested. (Tr. 647-48).

The Offering Memorandum for the units reveals plainly that the petitioners and the respondents understood that tax benefits were an important part of the return on any investment in Alotel Associates. Thus, the Offering Memorandum stated that Alotel Associates "is intended to operate as a 'tax shelter' and will lead to significantly greater returns for persons in relatively high income tax brackets; correspondingly returns will not be as great for those not in high income tax brackets. . . ." (J.A. 93; Pl. Ex. 2; Tr. 42). The investors were cautioned that pending Administration tax proposals could "eliminate the forecasted income tax savings for the years 1973 through 1976. . . ." (J.A. 106; Pl. Ex. 2; Tr. 42).

At trial, an expert for the defendants noted the importance of these tax savings as reducing the effective capital investment of each limited partner. (J.A. 183-85).

Included in the Offering Memorandum were various financial statements prepared by the accounting firm of Touche Ross & Co. The financial statements displayed projected operating results, and reflected projected tax savings per $35,000 unit on the assumption that the investor had a combined federal and Minnesota tax rate of 54%. (J.A. 116-17; Pl. Ex. 2; Tr. 42).[1]

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1 At a 54% combined federal and state tax rate, an investor is better off with a dollar of tax deductions than with a dollar of taxable income. A dollar of taxable income would leave 46 cents after taxes. A dollar of deductions would be worth 54 cents by reducing one's tax bill in that amount. This is why it is sometimes more important for tax shelters to provide paper losses for deductions than to provide taxable dollars to the investors. It also shows that such deductions are a genuine form of return on the investment—indeed, they can be more valuable than a return in dollars.

Equally important was an attorneys' opinion in the Offering Memorandum that Alotel Associates would be treated as a partnership for tax purposes (J.A. 111-12; Pl. Ex. 2; Tr. 42); without such treatment, there would be no pass-through of tax savings to the investors.

Laced throughout the Offering Memorandum were descriptions of various matters governing the tax consequences to the investors. (*See*, *e.g.*, J.A. 102-04, 106; Pl. Ex. 2; Tr. 42) (the allocation of profits and losses; the recapture of depreciation by Alotel Associates; the treatment of Alotel Associates as a dealer in real estate; the use of accelerated depreciation; the effect of pending legislation; and the attorneys' opinion and financial projections referred to above). Nearly every one of the 17 detailed notes to the financial statements had direct bearing on the estimated tax savings that an investment in Alotel Associates would yield. (*See* J.A. 120-29; Pl. Ex. 2; Tr. 42).

All profits and losses were allocated to the limited partners (J.A. 102-03; Pl. Ex. 2; Tr. 42), with the general partners taking a fee. This permitted deductible payments by Alotel Associates to the general partners, providing tax benefits to the investors above and beyond what would arise from the general partners' taking a share in the profits and losses.

To ensure that the investors obtained the tax benefits they expected, Alotel Associates, through the respondents, took a number of steps. Alotel Associates borrowed over $2.5 million, an amount approximately three times the amount invested by the limited partners. Borrowed funds increased each limited partner's basis and thereby increased the amount of deductible losses a partner could take. The borrowings were arranged exclusively by the respondents for Alotel Associates. Yet, the tax benefits flowing from Alotel Associates' use of the borrowed funds went directly to the petitioners as partners in Alotel Associates.

In addition, the general partners had to spend funds as required by the Internal Revenue Code to bring about the expected tax savings: a motel had to be built; franchise fees had to be paid; furniture had to be purchased; fixtures and other equipment had to be bought and installed; paving and landscaping had to be arranged; mortgage payments had to be made; insurance had to be secured; and so forth. (*See* J.A. 118; Pl. Ex. 2; Tr. 42). To the extent these and other expenditures did not come about, or came about in a different pattern, or even came about later rather than earlier, the value of the tax benefits arising from an investment in Alotel Associates would be altered substantially.

Subsequent Events

The motel began operating in June of 1974. (Tr. 670). After disputes arose, Loftsgaarden withdrew as general partner of Alotel Associates in September of 1975.

Both before and after Loftsgaarden withdrew as general partner, the petitioners and other investors lent funds to Alotel Associates, even after the misrepresentations in the Offering Memorandum were discovered. (*See* Tr. 466, 568, 591).[2]

In August-September 1975, when the petitioners discovered or should have discovered the fraud,[3] the petitioners made a conscious election to retain their investment. They could have tendered their shares to the respondents in 1975, but the result of a tender at that time would have been the loss of thousands of dollars in tax benefits. Instead, the petitioners chose to retain their shares.

In 1977, the mortgage lender foreclosed on the motel. *See United Realty Trust v. Property Development and Research*

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2 The jury found that in making the loans the petitioners no longer relied on the misstatements in the Offering Memorandum. (J.A. 81).

3 *See* Pet. App. E-13, Findings of Fact, Conclusions of Law and Order for Judgment by Judge Larson, dated August 15, 1980.

Co., 269 N.W.2d 737 (Minn. 1978). The foreclosure resulted in the reversal of some, but far from all, of the tax benefits the petitioners had received from their investment. In the case of Dr. Austin, for example, without the foreclosure his total tax benefits would have been $59,607 on a $35,000 investment. The foreclosure reduced the aggregate tax benefits to $33,333. The petitioners have since been audited by the Internal Revenue Service. The relevant tax years are closed. Their remaining tax benefits are now permanent. *See Austin II*, 768 F.2d at 955. Those benefits are listed below:

	Investment	*Permanent Tax Benefits*
Randall	$35,000	$36,404
Austin	35,000	33,333
Anderson	35,000	29,615
Neumann	52,500	57,014

(J.A. 211).

Institution of Suit

In 1976, the petitioners sued Alotel Associates' two general partners and other individuals and corporations,[4] asserting that statements made by them to induce the purchase of the units were false and misleading. (J.A. 11-16, 33-35). Originally, no claim was made under Section 12(2) of the 1933 Act; damages were sought under Section 10(b) of the 1934 Act. Complaint of February 24, 1976. Subsequently, a Section 12(2) claim was added and the petitioners tendered their shares pursuant to that provision in 1980, shortly before trial, after there were no more tax benefits to be obtained from ownership of the units.

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4 B.J. Loftsgaarden was one of the general partners of Alotel Associates. Alotel, Incorporated was the other general partner. Property Development and Research Company ("PDRC") was to obtain the real estate required in the venture. 2361 Building Corporation ("2361 Corp.") was the project's general contractor. *See Austin I*, 675 F.2d at 173 & n.4. Loftsgaarden was the sole shareholder of the corporate defendants. *Id.* at 173. (Unless the context indicates otherwise, "the respondents" hereinafter refers to the general partners, Loftsgaarden and Alotel, Incorporated.)

The jury found that the respondents had made untrue statements or omitted to state material facts in violation of Section 12(2) of the 1933 Act and Section 10(b) of the 1934 Act. (J.A. 79, 82, 84, 86). The issue before the Court relates solely to the measure of damages under these statutes.

There is no issue before the Court as to the respondents' liability, nor is there any issue whether the respondents were "unjustly enriched" from the petitioners' funds, despite the petitioners' repeated contentions to the contrary throughout their brief. The Eighth Circuit expressly found in *Austin II*, "it does not appear that the defendant has 'retained' any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project." 768 F.2d at 956.[5]

Based on the foregoing and related facts, the Eighth Circuit and trial court determined that:

> (a) tax benefits were at the heart of this investment which was marketed and sold as a tax shelter (*Austin I*, 675 F.2d at 182-83);
>
> (b) the amount of anticipated tax benefits affected the desirability of the investment, or the price the investors would pay (*Id.* at 174);
>
> (c) the tax benefits were achieved through the respondents' application of Alotel Associates' funds, including, predominantly, borrowed funds raised by the respondents (*Id.* at 173-74);
>
> (d) the tax deductions and credits giving rise to the benefits were generated by Alotel Associates and passed through to the petitioners because Alotel Associates was

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5 Moreover, at trial, the petitioners specifically dropped claims that Loftsgaarden and Alotel, Incorporated breached fiduciary duties owed to the limited partners (Tr. 730), even though those claims related to alleged improper profits made by Loftsgaarden's controlled corporations, improper cost allocations, mismanagement and usurpations of partnership business opportunities. (J.A. 22-24, 43-45). These are the very bases of the petitioners' "unjust-enrichment" theories here. This issue is a red herring, which we treat in IV.G., *infra*.

set up and maintained as a partnership for tax purposes (*Id.*);

(e) the petitioners received the tax benefits (*Austin II*, 768 F.2d at 955);

(f) the tax benefits were of value (*Id.*); and

(g) the tax benefits are now permanent (*Id.*).

SUMMARY OF THE ARGUMENT

Tax shelters provide genuine economic returns to investors in the form of tax benefits. Tax shelter investors consider their tax benefits to be part of the return on their investment, and the availability of such benefits is at the heart of the investment decision. Indeed, the SEC's and others' definitions of a tax shelter turn on how material the tax benefits are to an investment decision. The motel tax shelter involved in this case could not be marketed successfully until the tax benefits it contemplated were increased; without such an increase, investors were not interested in investing in the motel. (Point I.)

Damages under Rule 10b-5 are to compensate investors for their net economic loss and return them to the *status quo ante*. This is required by the statutory limitation on a damage recovery to actual damages, a limit which has been consistently applied. One way to accomplish this is through rescissionary damages, or other forms of relief, all designed to put the parties back in the economic positions they were in before the events. Here, subtraction of tax benefits is necessary lest the petitioners receive a windfall and the respondents be subjected to an unfair penalty, results which are inconsistent with the statutory limitation. (Point II.A.)

While the petitioners argue that the tax benefits were "collateral" to the investment, the opposite is true. With fewer tax benefits contemplated, the motel project could not attract sufficient investors. It was only through the partnership and the respondents' efforts that the petitioners were able to obtain

the tax benefits. The fact that the benefits were ultimately conferred by the Government does not mean they were collateral, any more than it would if the partnership distributed promissory notes to the limited partners and they obtained payment on the notes from the payors. (Point II.B.)

The rescissionary measure of damages under Section 12(2) of the 1933 Act must be read *in pari materia* with the "actual damages" limitation of the 1934 Act, lest the penalty for negligence, the Section 12(2) standard, exceed that for scienter, required under Rule 10b-5. The courts have generally read the statutes *in pari materia* for this and related reasons. (Point II.C.1.)

Turning to the language of Section 12(2), we agree with the Government that the provisions must be read in the light of the common law of restitution. These principles support the lower court. At common law, the plaintiff had to return everything of value he had received in the transaction, or subtract that value from the damage award, which amounts to the same thing. The term "income received" in the statute should be understood as the lower court read it, to mean value received, the meaning consistent with the common law origin of the remedy. A different interpretation ignores economic reality. (Point II.C.2.)

The lower court correctly applied interest to the net amount the petitioners were out of pocket in each year. The petitioners do not contest this treatment under Rule 10b-5, but argue that it is inappropriate under Section 12(2) because of the location of the word "interest" in the statute, after the term "consideration paid" and before the term "income received." Viewing tax benefits as reducing the net investment, or "consideration paid," avoids the petitioners' argument, and is consistent with both sides' expert testimony. Apart from this, nothing in the statute prevents a court in its discretion from imputing interest on the "income received," all to the same effect. The petitioners' approach creates a windfall for them by compensating them for more than their damages, and a penalty to the

respondents. Such an interpretation should be avoided. (Point II.D.)

We ask the Court to correct, under the "plain error" rule (U.S. Sup. Ct. Rule 34.1(a)), the lower court's doubling the interest portion of the award; there is no objection to its having doubled the damage portion. Unlike the damage portion of the award, which is taxable precisely because of the recognition of earlier tax benefits, the taxability of interest as ordinary income has nothing to do with the tax benefits conferred here. The purpose of interest is to compensate for income lost; to award the petitioners what amounts to after-tax interest treats them more favorably than other investors under the securities laws for no reason. (Point III.)

In Point IV., we briefly treat the petitioners' miscellaneous other arguments.

ARGUMENT

I. Tax Benefits Created And Distributed By Tax Shelters Are A Return On An Investment

Taxes are an inevitable part of our economic lives. An industry has grown up to marshall and sell tax savings through tax shelters. These shelters have as many forms as there are governmental incentives to economic activity administered through the tax laws. *See generally* R. Haft & P. Fass, *1985 Tax Sheltered Investments Handbook* (1985) (examining real estate, oil and gas, equipment leasing, farming and other tax shelters).

Tax shelters provide benefits in a variety of ways to investors. Relevant here are tax credits, depreciation, deferrals, and leveraging.

Tax credits are provided for certain expenditures the government encourages, most notably purchases qualifying for the investment tax credit.[6] Investors are entitled to deduct from

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6 26 U.S.C. § 46.

their tax bills, as a credit, a percentage of every dollar a motel tax shelter like Alotel Associates spends on items such as television sets and refrigeration equipment.

Although most business expenses are deductible, depreciation deductions were among the largest involved here. Alotel Associates was authorized under the tax laws to depreciate its property over a shorter time than its actual life,[7] resulting in greater deductions for the investors than would have been available without accelerated depreciation.

Tax deferrals are also important to investors. Because of the time value of money, it is valuable to be able to defer a tax payment from a given year into the future. Because deferrals do not alter one's aggregate tax liability, the petitioners have argued that some or all of the tax benefits here were illusory. This misses the point. A deduction of a dollar in year one is still valuable even though it may result in a recapture of a dollar of income in year ten. Here, the largest item of deferral arose from accelerated depreciation, where some, but not all, of the early deductions were recaptured in later years.

Leveraging is one of the most important tools in tax shelter investments. Alotel Associates, for example, borrowed three times what the investors put up as their investments; yet, the various deductions and credits arising from appropriate expenditures all went to the investors, even if the borrowed funds were used for those expenditures. This had a multiplier effect on the amount of tax benefits available to the petitioners from their investment.

Tax shelters serve a vital role in attracting capital to investments that would not be made without a form of governmental subsidy. Thus, a book introducing investors to tax shelters states that tax shelters:

> result from a conscious decision on the part of Congress that various key industries, vital to the economy, can best

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7 26 U.S.C. § 167.

> be financed by attracting capital through the technique of granting tax incentives for such investment, rather than by supporting such industries through direct government subsidies or government owned and operated companies.
>
> . . . .
>
> The Congressional decision to encourage investment in various critical industries also reflects the fact that the historic return on dollars invested in such industries is not high enough to attract sufficient capital to the industry without the encouragement of the tax incentives.

L. Mosburg, *Tax Shelter Desk Book* 1-2 (1978).

The critical feature of tax shelters is the use of tax benefits to enhance the return on investments the Government seeks to encourage. Thus, in considering a tax shelter, an investor evaluates his tax benefits along with the other aspects of his return:

> Return from a tax sheltered investment will consist of cash flow, tax benefits and appreciation equity value. The three elements of return are normally interdependent. . . . Generally however, if tax benefits are increased, such increase will be at the expenses of cash flow and the appreciation potential. If either cash flow or appreciation potential are enhanced, such enhancement may be at the expense of the other return component.
>
> Since all three items of return are relevant, no method of analysing the rate of return on the investment should fail to take into account all of the components.

R. Haft & P. Fass, 4 *Tax Sheltered Investments*, Intro. 8-9 (3rd ed. 1981).

In many cases, the initial beneficiary of these tax benefits is a form of business organization that engages in the type of activity sought to be fostered. If the entity is a corporation, it uses the tax benefits to reduce its own tax obligation. In some circumstances, the corporation can transfer or even sell these

tax benefits if, for example, through a lack of taxable income, it cannot use the tax benefits itself.[8] In the hands of the transferee, the tax benefits are the functional equivalent of vouchers with which to pay taxes.

When the business organization is a partnership meeting certain tests under the Internal Revenue Code, the tax benefits are distributed among the partners by operation of the tax laws; the partnership is transparent for tax purposes. *See* 26 U.S.C. § 701 *et seq*. If a partner transfers his partnership share, future tax benefits accrue to the new owner because the right to the tax benefits, like the right to returns from investments generally, is an incident of ownership.

The very definition of a tax shelter therefore turns on how material this pass-through of tax benefits is to the investor. The Securities and Exchange Commission, for example, defines a tax shelter as:

> an investment in which flow-through tax benefits are a material factor affording investors relatively large deductions and lower income tax rates.

SEC Release No. 34-10260 [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,417, at 83,192 n.2 (July 2, 1973).

Similarly, the American Bar Association Committee on Ethics and Professional Responsibility defines a tax shelter as:

> [a]n investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.

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8 *See, e.g.*, 26 U.S.C. § 168(f)(8) (permitting so-called safe harbor leases); § 382 (permitting transfers of tax losses in specified circumstances).

ABA Comm. on Ethics and Professional Responsibility, Revised Formal Op. 346, n.1 (1982) (tax shelters).

The investor's perception of tax benefits as a return on his investment is no more manifest than in litigation spawned by tax benefits gone awry. Disappointed investors in tax shelters have sued those who have undertaken, but failed, to supply various forms of tax benefits. *E.g.*, *Lasker v. Bear, Stearns & Co.*, 757 F.2d 15, 16-17 (2d Cir. 1985) (fraud and breach of contract for ineffective tax straddles); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (alleged fraud as to existence of tax benefits), *cert. denied*, 455 U.S. 938 (1982).

Alotel Associates described itself as a tax shelter and was marketed and sold as such. The Offering Memorandum was rife with descriptions of the tax benefits from the investment as well as what might impair them. Indeed, if Alotel Associates' units were being offered to the public today, the Securities and Exchange Commission's Rules would require substantial disclosures as to tax benefits (and risks relating to them) precisely because they are material—if not central—to an investment decision:

> In a registration statement for a limited partnership, it is generally the case that tax consequences of an investment are material and thus are discussed in the prospectus. This derives in part from the Commission's specific guidance as to disclosure of tax matters in offerings involving real estate limited partnerships. See, Guide 5 of the Securities Act Industry Guides.

Hopper, Kanouff, Smith & Peryam (SEC Staff Interpretative Letter) (available October 11, 1982).[9]

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9 Industry Guide No. 5, Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships, requires inclusion of opinions on a variety of tax issues relating to limited partnerships, with an emphasis on the risks that anticipated tax benefits will be lost through failure to meet formal requirements or through economic events. Fed. Sec. L. Rep. (CCH) ¶ 3829 at 3338-39, 3342-45 (May 24, 1982).

Both the Eighth and Second Circuits have recognized the economic reality of tax benefits produced by tax shelters. *Austin II*, 768 F.2d at 955 (plaintiffs' tax benefits are "economic benefits bargained for and received"); *Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984) ("tax benefits to the partner represent an important tangible economic advantage expected to be derived from his investment"), *pet. for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447) (hereinafter "*Salcer*").

For this reason, many courts have agreed with or anticipated the decisions of the Eighth and Second Circuits. In *Bridgen v. Scott*, 456 F. Supp. 1048 (S.D. Tex. 1978), a Rule 10b-5 case brought by limited partners in a real estate tax shelter investment, the court said:

> Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial "never-never land." The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.

Id. at 1061.[10] The *Bridgen* Court relied in large part on the Fifth Circuit's holding in *Dupuy v. Dupuy*, 551 F.2d 1005,

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10 *See Herber v. Omega Oil Corp.*, No. 85-C-384, slip op. at 17 (N.D. Ill. Nov. 1, 1985) (plaintiff's "recovery in a rescissionary remedy should probably be reduced by any 'tax shelter' or other benefit he reeeived as a result of his investment") (available on LEXIS, Genfed library, Dist file); *Feldman v. Pioneer Petroleum, Inc.*, 606 F. Supp. 916, 923 (W.D. Okla. 1985) (tax benefits must be considered in evaluating the actual damages suffered); *Smith v. Bader*, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) ("knowledge of plaintiffs' income tax rate and the net value of their investment, along with other information, may be needed to calculate any tax benefits which may mitigate damages"); *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980) (no damages if, "because of income tax considerations, . . . the selling price equaled the market value of the property").

1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977), that the district court did not abuse its discretion in considering tax benefits in a fraud action under the securities laws.

These decisions demonstrate judicial recognition of an economic fact—that tax benefits "represent an important tangible economic advantage expected to be derived" from a tax shelter investment. *Salcer*, 744 F.2d at 940.

The petitioners do not quarrel with this, but argue that the respondents seek a "treatment" for tax shelters that "differs" from that for other investments, and that the securities laws do not authorize such a distinction. Brief for Petitioners at 13-16.

The respondents seek only recognition that the law of damages requires subtraction of value bargained for and received on an investment. For tax shelters, at least as defined by the SEC and others, that value is in the form of tax benefits.[11]

II. Damage Awards Under The Securities Laws Are Reduced By Returns On The Investment, Including Tax Benefits From Tax Shelters

A. *Tax Benefits Must Be Subtracted Under Rule 10b-5*

Under Rule 10b-5, the petitioners are entitled to be restored to the *status quo ante* and no more. That result has been accomplished by starting with their investment and subtracting the value of the tax benefits they received—a rescissionary measure of damages. *Austin II*, 768 F.2d at 953-54.

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11 To the extent the petitioners cite tax shelter securities cases that may be read as differing with the Eighth and Second Circuits, such cases, at best, only express the conflict in the lower courts; they do not aid in resolving it. *See, e.g.*, Brief for Petitioners at 27-29. The other cases the petitioners rely on do not involve the kind of tax benefits flowing from the ownership of an investment as contemplated by tax shelters. They deal instead with such matters as the tax consequences of a disposition of the investment—consequences that were not part of the securities offering or the investment decision and were not part of the value bargained for and received.

Other methods of restoring a plaintiff to the *status quo ante* are widely used,[12] most commonly the out of pocket rule, which in the case of a defrauded buyer measures the difference in value between what he paid and what the securities were actually worth.[13]

Restoring a plaintiff to the *status quo ante* in cases such as this is based on the "actual damages" limitation in Section 28(a) of the 1934 Act, which provides:

> . . . no person permitted to maintain a suit for damages under the provisions of [the 1934 Act] shall recover,

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12 *See* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][ii]-[vi] at 11-27 to 11-87 (2d ed. 1985) (measures of damages include: out of pocket, resale or "*Chasins*," cover, benefit of the bargain, and rescissional or restitutional damages); L. Loss, *Fundamentals of Securities Regulation* 1132-39 (1983) (general rule is out of pocket measure qualified by eight "voracious" exceptions to the rule).

13 The petitioners paid the amount of their investment and got shares whose only value, as it happened, was from tax benefits. An out of pocket measure of damages accordingly would produce the same subtraction as the rescissionary measure used here. Although in a different context, Judge Larson correctly ruled, "[i]n this case, however, an out-of-pocket or a rescissionary measure would yield the same results." Pet. App. F-7, Memorandum Order by Judge Larson, dated August 15, 1980. *See generally* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][vi][B] at 11-83 (2d ed. 1985) (out of pocket measure theoretically equivalent to rescissionary damages where plaintiff buys security for cash).

The cases where rescissionary damages would produce a different outcome from the out of pocket rule are not relevant here. They are (a) where the security has appreciated in the hands of a defrauded buyer, or (b) where it has lost its value after being sold by a defrauded seller. In both cases it would be unusual to find the defrauded person suing.

The final permutation is (c) the defrauded seller whose stock appreciates in the hands of the fraudulent buyer; here rescission helps the plaintiff seller more than a strict out of pocket rule, and is usually justified on the basis of "unjust enrichment" arising from the security's appreciation in the hands of the fraudulent buyer. This was the case in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), relied on by the petitioners as supporting their claim for a recovery beyond their actual damages.

> through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Thus, the Second Circuit, in the light of Section 28(a), has characterized the rescissionary measure of damages as follows:

> The rescission theory of damages which we essentially utilize here cannot restore a plaintiff to a *better* position than he would have been in if the fraud had not occurred.

Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 49 n.22 (2d Cir.) (emphasis in original), *cert. denied*, 439 U.S. 1039 (1978).[14] In this respect, the limitation to "actual damages" parallels the common law rule for actions in deceit:

> [The aim of compensation] would seem to direct the courts in giving damages for deceit, to resort to a similar measure to that used in cases of rescission, and to try to place the plaintiff, as nearly as possible, financially on a par with his position before he was defrauded. In other words, the plaintiff would recover the value of what he has parted with under the fraudulent inducement, less the value of what he got under the bargain.

C. McCormick, *Handbook on the Law of Damages* § 121 at 449 (1935).[15]

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14 *See also Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 604 (2d Cir. 1978) ("total rescission damages are the difference between the price she paid and the price she received for the debentures . . . plus such accrued interest as she may have been required to pay at the time of purchase, less such interest as she may have received during the period she held the securities"); *Richardson v. MacArthur*, 451 F.2d 35, 43 (10th Cir. 1971) (buyer's recovery reduced by " 'dividends or any other payments received from the defendant seller' ").

15 *See generally Smith v. Bolles*, 132 U.S. 125, 129-30 (1889) (stating the pre-*Erie* federal common law). The common law doctrines of rescission and restitution are treated more fully in II.C.2., *infra* (dealing with Section 12(2) of the 1933 Act).

Under these principles, it is logical that the courts have uniformly prohibited an award of punitive damages under Rule 10b-5.[16] For the same reasons, the courts have also ruled that Section 28(a) precludes an award of attorneys' fees.[17] Section 28(a) and Rule 10b-5 have been interpreted in this way at least since *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962) (out of pocket limitation applied to defrauded buyer). Congress has not acted to alter this, although the securities laws have been amended many times over the years, and Section 28(a) itself was amended in 1982 with no change in the "actual damages" language. *See* Act of October 13, 1982, Pub. L. No. 97-303, Sec. 4, 1982 U.S. Code Cong. & Ad. News (96 Stat.) 1409. Under analogous circumstances this Court remarked:

> In 1975 Congress enacted the "most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934." . . . When Congress acted, federal courts had consistently and routinely permitted a plaintiff to proceed under § 10(b) even where express remedies under § 11 or other provisions were available. In light of this well-

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16 *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 559 n.46 (5th Cir. 1981) (Unit A) (Section 28(a) precludes recovery of punitive damages), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983); *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977) (on its face Section 28(a) precludes recovery of punitive damages); *Straub v. Vaisman and Co., Inc.*, 540 F.2d 591, 599 (3rd Cir 1976) (prohibition on recovery in excess of actual damages bars recovery of punitive damages); *see also* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[e] at 11-131 to 11-132 (2d ed. 1985) ("all [authorities] concur that the words 'actual damages' preclude punitive damages"); L. Loss, *Fundamentals of Securities Regulation* 1139 (1983) ("[I]t is clear that punitive or exemplary damages are precluded by the limitation in § 28(a) to 'actual damages.' ")

17 *See, e.g., Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1014 (11th Cir. 1985); *Huddleston*, 640 F.2d at 559; *Straub*, 540 F.2d at 599.

> established judicial interpretation, Congress' decision to leave § 10(b) intact suggests that Congress ratified the cumulative nature of the § 10(b) action. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-382 (1982); *Lorillard v. Pons*, 434 U.S. 575, 580-581 (1978).

Herman & MacLean v. Huddleston, 459 U.S. 375, 384-86 (1983) (footnotes omitted).

Applying the general rules of rescissionary damages under Rule 10b-5 to the present case, the central question is what would it take to return the petitioners to the *status quo ante*. Putting aside the issue of interest for a moment, the answer is: just what the Eighth Circuit gave them. In view of the permanence of the petitioners' tax benefits, any greater recovery than that permitted by the Eighth Circuit would, in conflict with Section 28(a), produce a windfall for the petitioners and a forfeiture or penalty for the respondents.

The petitioners, citing *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981), contend that the "actual damages" provision was "meant only to prevent duplicative recoveries when a plaintiff asserted a state law claim as well as a federal securities law claim." Brief for Petitioners at 23. This is a distortion of *Osofsky*. The petitioners' interpretation omits language from *Osofsky* that, in addition to prohibiting a duplicative recovery, Section 28(a) also prohibits awards of punitive, as opposed to compensatory, damages. *See Osofsky*, 645 F.2d at 111.[18] And,

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18 The petitioners also cite cases and statutes defining the phrase "actual damages" as used in patent, copyright, and trademark law. The petitioners quote from the Court's opinion in *Birdsall v. Coolidge*, 93 U.S. 64, 64 (1876), defining "actual damages" as used in a patent statute. In *Birdsall*, the Court stated that "[c]ompensatory damages and actual damages mean the same thing; that is, that the . . . amount awarded shall be precisely commensurate with the injury suffered, neither more nor less. . . ." *Id.*

To the extent the petitioners' authorities discuss tax consequences, they are totally inapposite. *See L.P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co.*, 277 U.S. 97 (1928) (infringer of competitor's gum packaging denied subtraction

of course, the Second Circuit was well aware of its decision in *Osofsky* when it decided *Salcer* directly contrary to the petitioners' position. *Salcer*, 744 F.2d at 939-40 (citing *Osofsky*).

The Government, on the other hand, would have the courts rely on the tax code to prevent windfalls, as if, should this Court increase the petitioners' award, the Internal Revenue Service would confiscate the entire increase:

> [T]he Internal Revenue Code incorporates sophisticated mechanisms for preventing undeserved windfalls to taxpayers in circumstances like those here. Those mechanisms, unaided by the court of appeals' tinkering, will achieve the result that the court of appeals desired, and will do so in the manner that Congress has ordained.

Brief for Government at 23.

This is nonsense. The petitioners would not be here if the Government was going to take away any increase in the award they hope to achieve.[19] Even if this were true, there is simply

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of income taxes paid); *Wolfe v. National Lead Co.*, 272 F.2d 867 (9th Cir. 1959) (trademark infringer not permitted to subtract income taxes paid), *cert. denied*, 362 U.S. 950 (1960); *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99 (2d Cir. 1951) (copyright infringer not permitted to subtract income taxes paid); *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45 (2d Cir. 1939) (copyright infringer prohibited from subtracting income taxes paid), *aff'd*, 309 U.S. 390 (1940); *Goodyear Tire & Rubber Co. v. Overman Cushion Tire Co.*, 95 F.2d 978 (6th Cir. 1938) (patent infringer prohibited from subtracting income taxes paid), *cert. dismissed*, 306 U.S. 665 (1939); *Carter Products, Inc. v. Colgate-Palmolive Co.*, 214 F. Supp. 383 (D. Md. 1963) (patent infringer and trade secret misappropriator prohibited from subtracting income taxes paid). As a general matter, damage payments by the defendants in these cases would be income to the patentee. *See Carter Products*, 214 F. Supp. at 406 (patent and trade secret holder would be required to pay income taxes on amount recovered). In this respect, the cases resemble the authorities we treat in IV.A., *infra*, and are distinguishable on the same grounds.

19 *See Austin II*, 768 F.2d at 955 (petitioners' tax benefits are permanent and cannot be recouped by the Government); *see also* IV.B., *infra*.

no need for it; the petitioners are whole now. What point would be served by having the respondents pay more simply to benefit the Treasury? Such a payment would constitute the very sort of penalty that Section 28(a) prohibits, since the tax credits and deductions were proper under the Internal Revenue Code and the petitioners already have been made whole.

B. *The Collateral Source Rule Does Not Apply*

The principal reason the petitioners give for neglecting the tax benefits—plainly of economic value to them—is that the benefits came from the Government and not from their investment,[20] and that the collateral source rule bars consideration of benefits received from a third party in determining the extent of the respondents' liability. Brief for Petitioners at 29-31. This confuses the entity which ultimately confers the benefit (in this case, the Government) with the entity which, itself having the right to the benefit (Alotel Associates), transferred that right to the petitioners.[21]

The collateral source rule:

> prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently. Restatement (Second) of Torts § 920A(2) (1979). A classic example is the court's ruling in a personal injury action that a plaintiff's recov-

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20 We assume that the petitioners do not argue that there is to be a different result if some benefit came from their investment rather than from those they chose to sue. Such a position would be illogical since the receipt of the benefits is one of the consequences of a fraudulently induced investment, and such a position would deny an offset even in the case of cash dividends.

21 The petitioners received tax benefits in this case because the real estate venture was set up as a partnership, and all deductions and tax credits passed through to the partners. 26 U.S.C. § 702. If the venture had instead been set up as a corporation, then the respondents' same efforts would have resulted in tax deductions and credits for the corporation rather than for the petitioners.

> ery is not to be reduced by any insurance proceeds received under his independent insurance policy in which the defendant played no part.
>
> The essence of the collateral source rule is the independence of the transaction giving rise to the collateral source, such as the insurance policy.

Salcer, 744 F.2d at 941.

In this case, Alotel Associates received $157,500 from the petitioners and borrowed over $2 million. The respondents used these funds to purchase property, to do paving and landscaping, to buy fixtures and furniture, and so on—in short, to build a multi-million dollar motel. Only by virtue of the respondents' efforts to build a motel in accordance with the tax code criteria were tax benefits created. Because of the form of the venture, organized and maintained as a partnership for tax purposes, these tax benefits passed through to the petitioners. To characterize the respondents' efforts as "collateral" to the petitioners' receipt of tax benefits ignores reality.[22] Nothing emphasizes this so much as the respondents' securing loans for Alotel Associates. The respondents obtained these funds exclusively through their own efforts; Alotel Associates' expenditure of these funds, amounting to some three times what the investors advanced, resulted in three times more tax benefits than the investors would have received without the respondents' having secured the loans. Thus, the respondents not only saw to the proper expenditure of the petitioners' funds, but acquired and spent borrowed funds to greatly

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22 That the tax benefits are not collateral is further evident when one considers that the respondents could have been liable to the petitioners for damages had the respondents been unable to secure tax benefits for them. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (absence of represented tax benefits is one component of fraud), *cert. denied*, 455 U.S. 938 (1982); *Beggs v. Dougherty Overseas, Inc.*, 287 F.2d 80, 83 (2d Cir. 1961) (where tax benefits were considered by parties when they entered into employment contract, lost tax benefits were allowed as damages in wrongful discharge action).

enhance the benefits the petitioners received. As the Second Circuit stated in *Salcer*:

> the tax benefits, although paid by the government, emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award.

744 F.2d at 941-42.[23]

The petitioners assert that a defendant could always argue that a collateral source payment results "directly" from his efforts in the sense that but for his tortious conduct there would have been no payment. The petitioners argue that the inquiry should therefore be simply "whether the benefit is conferred on an injured party from a source other than the defendant." Brief for Petitioners at 31. The petitioners have, however, cited no cases in which the collateral source rule barred taking into account benefits received by a plaintiff through a defendant's direct and intentional efforts—efforts that the plaintiff sought and expected the defendant to make—as is the case here.[24]

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23 *See* Note, *Tax Shelter Schemes and Damages in the Eighth Circuit—Hayden v. McDonald*, 18 Creighton L. Rev. 1307, 1327 (1985) ("The realities of the situation suggest that without the defendant/promotor's creating such an investment, there would be no tax deductions available to the plaintiff. . . . Thus, the [collateral source] doctrine should not apply. . . ."); Note, *Tax Consequences of Rescission: The Interplay Between Private and Public Law*, 42 U. Chi. L. Rev. 562, 567-68 (1975) (tax consequences in a tax shelter project are not collateral, since "the tax consequences . . . are at the heart of the bargain" and "are at least as much the object of the transaction between the parties as the anticipated flow of profits," and if the seller failed to provide the tax benefits promised he might be liable to the purchaser in damages for them).

24 The petitioners have cited cases where defendants were not permitted to offset against damage awards disability or unemployment benefit payments made to plaintiffs from state or federal funds to which defendants had indirectly contributed, through taxation or otherwise. *Eichel v. New York*

A source of confusion about the collateral source rule is the inevitable fact that there are three parties to the tax benefit transaction involved here: the petitioners, the respondents, and the Government. The fact that one of the parties ultimately confers the benefit does not alter the fact that another party secured the right to the benefit and passed it to the third. An example clarifies this. Suppose that Alotel Associates took the petitioners' funds and purchased certificates of deposit from a bank. Suppose further that Alotel Associates then distributed all of those certificates to the petitioners, who promptly took them to the bank and received payments equaling their original investments. Meanwhile, their partnership interests became worthless and they commenced an action for fraud. It would be unthinkable that they could recover under these circumstances simply because the payments they received ultimately came from a bank rather than from Alotel Associates. Whether Alotel Associates spent its funds to secure certificates of deposit for the petitioners or to secure tax benefits for them is immaterial.[25]

Cent. R. Co., 375 U.S. 253, 254 (1963) (Railroad Retirement Act benefits not directly attributable to employer's contributions); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951) (state unemployment compensation); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1982) (Court of Appeals, noting a split among the circuits, disallows deduction of unemployment benefits from backpay award under Title VII). These cases have no bearing here.

The petitioners' citations (Brief for Petitioners at 31) to "tax benefit" cases are inapposite as well, because in none of those cases did the defendant cause the plaintiff to receive tax benefits. In fact, in *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d 79, 81, 147 N.E 2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958), cited by the petitioners, the court stated that it would not consider the plaintiff's tax savings because "[t]he defendants *did not cause* nor did they provide the funds for the [plaintiff's] tax refund." (emphasis added).

25 It is no answer to the example in the text that, unlike a certificate of deposit, tax benefits have no fixed value until they are in the hands of one with taxable income against which to use them. Whether the value of the tax benefits is fixed when they are earned by the partnership's expenditures, or is fixed later on, does not alter the fact that the tax benefits had value and that

C. *Tax Benefits Must Be Subtracted Under Section 12(2)*

1. *Section 12(2) Must Be Read* In Pari Materia *With Rule 10b-5*

Section 12(2) permits an investor who has been induced to purchase a security by a misleading prospectus or oral communication to sue the offeror or seller of the security:

> . . . either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

After asserting that the history and language of Section 12(2) do not permit courts to subtract tax benefits produced by tax shelters from securities damage awards, the Government argues that rules of statutory interpretation require the same damage award under Rule 10b-5 and Section 12(2). Brief for Government at 20. We agree with the Government that the two securities statutes are to be construed *in pari materia*,[26] but the conclusion that follows from this is opposite to the Government's. The effect of interpreting the statutes *in pari materia* is to construe the language of the 1933 Act to provide the same remedy as the 1934 Act.

It would be anomalous to impose a harsher penalty under Section 12(2), which gives a claim for lack of "reasonable care," than under Rule 10b-5, where liability may only be imposed for conduct involving scienter. *See Ernst & Ernst v.*

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such value came about as a direct result of the respondents' efforts in building the motel and applying the funds they received in the manner prescribed by the Internal Revenue Code.

26 *See Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); *United States v. Naftalin*, 441 U.S. 768, 778 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976); *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963).

Hochfelder, 425 U.S. 185, 194-214 (1976) (comparing the standards).

Similarly, in *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), the leading case in the area, the Second Circuit decided that punitive damages may not be awarded under Section 17(a) of the 1933 Act for among other reasons the "actual damages" limitation of the 1934 Act. The *Globus* Court noted that punitive damages are unavailable for a violation of Section 10(b) of the 1934 Act, 418 F.2d at 1283, and that Section 17(a) is "virtually identical" to Rule 10b-5, "except that the statutory provision applies only to the conduct of sellers, while the rule governs the conduct of both buyers and sellers." *Id.* at 1279 n.1. The court thought it would create an "unfortunate dichotomy" between the two Acts if sellers and buyers were prohibited from recovering punitive damages under the 1934 Act but buyers could recover punitive damages under the 1933 Act for equally blameworthy behavior. *Id.* at 1286.[27]

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27 Courts have applied the *in pari materia* doctrine across a broad spectrum of 1933 Act and 1934 Act provisions. *See, e.g., Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 308 (8th Cir. 1982) (reading the two Acts *in pari materia* to find no inconsistency between Section 12(2) and Section 10(b) or Rule 10b-5); *Gunter v. Hutcheson*, 674 F.2d 862, 876-77 (11th Cir.) (reading the two Acts *in pari materia* to apply defense available under Section 29(c) of the 1934 Act to claim under Section 17(a) of the 1933 Act), *cert. denied*, 459 U.S. 826 (1982); *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1065-66 (10th Cir. 1976) (affirming lower court's holding that "security" is not to be defined differently under 1934 Act than under 1933 Act), *cert. denied*, 431 U.S. 965 (1977); *Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255, 1267 (4th Cir.) (reading Section 29(b) of the 1934 Act *in pari materia* with other securities laws remedies), *cert. denied*, 419 U.S. 1023 (1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1298 n.65 (2d Cir. 1973) (relying "without discussion on the proposition that the 1933 and 1934 Acts are to be construed *in pari materia*" in examining Sections 11 and 12 of the 1933 Act and Sections 10(b) and 20(a) of the 1934 Act).

2. *Regardless Of* In Pari Materia *Concepts, Tax Benefits Must Be Subtracted In Rescission And Restitution Under Section 12(2)*

We agree with the Government that Section 12(2) must be understood in the light of the common law of rescission and restitution. These principles support the decision below and lead to the same measure of damages as under Rule 10b-5.

Rescission is the act of undoing the original transaction, and restitution is the return of property to each party in an effort to restore the *status quo ante*. *See* D. Dobbs, *Handbook on the Law of Remedies* § 4.1 at 222 (1973); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][vi] at 11-56, 11-65 (2d ed. 1985); C. McCormick, *Handbook on the Law of Damages* § 121 at 448 (1935); *see also* 2 J. Story, *Commentaries on Equity Jurisprudence* § 962 (1918) ("Necessity of Placing Parties in Statu Quo."). As noted above, this purpose parallels that of Rule 10b-5. *See* II.A., *supra*.

A party seeking rescission and restitution must restore whatever he has received from the transaction:

> [I]t is well settled that any person demanding the rescission of a contract to which he is a party must restore or offer to restore to the other party whatever he may have received under the contract in the way of money, property, or other consideration or benefit.

2 H. Black, *Black on Rescission & Cancellation* § 617 at 1417 (1916). Similarly, Professor Corbin states that where a defendant has "rendered a part performance of value," his "part performance must be allowed as a credit against the value of the full performance promised by the defendant." 5 A. Corbin, *Corbin on Contracts* § 1114 at 607 (1964). *See also* D. Dobbs, *Handbook on the Law of Remedies* § 9.4 at 622 (1973) (rescinding plaintiff must tender "whatever he . . . got under the contract, or at least its money value"); 1 G. Palmer, *The Law of Restitution* § 3.11 at 294 (1978) (when plaintiff seeks restitution under contract he must return or account for "the value he

received"); *Restatement of Restitution* § 65 (1937) (right of restitution in transaction voidable for fraud or mistake "is dependent upon his return or offer to return to the other party anything which he received as part of the transaction or, . . . its value"); 2 J. Story, *Commentaries on Equity Jurisprudence* §§ 962-966 at 341-45 (1918) (general rule of rescission requires that plaintiff must return defendant to *status quo*). The restoration requirement exists whether the "right to restitution is based on fraud, innocent misrepresentation, breach of contract, or any other ground." 1 G. Palmer, *The Law of Restitution* § 3.11 at 294 (1978). *See also Restatement of Restitution* § 65 (1937).

To fail to require the plaintiff to restore the value of the defendant's performance may unfairly benefit the plaintiff:

> A plaintiff who recovers the full value of such performance as he may have rendered, and at the same time is allowed to retain a part performance that he had received, is thereby put in a better position than he occupied before the contract was made. This is contrary to the theory of [restitution]. . . .

5 A. Corbin, *Corbin on Contracts* § 1114 at 607 (1964).

The result urged by the petitioners and the Government is a prime example of the outcome against which Professor Corbin cautioned. Permitting the petitioners both to retain the tax benefits produced by the respondents' efforts and to recover the full consideration they paid for their initial investment would put the petitioners in a much better net economic position than they occupied before entering the transaction.[28]

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28 Relying primarily upon the language of the *Restatement of Restitution* § 157, the Government argues that in calculating a restitutionary award the plaintiff buyer is required to restore to the defendant only the "direct product" of the plaintiff's security ownership. Brief for Government at 10. Even assuming, without conceding, that tax benefits are not a "direct product" in this case, the Government's position elevates a single nebulous formulation of the rule to talismanic proportions and ignores the concept underlying the rule.

Based on these principles, the Eighth Circuit correctly interpreted Section 12(2) to require the subtraction of tax benefits produced by the Alotel Associates tax shelter to effect restitution and return the parties to the *status quo ante*.

Citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (Brief for Petitioners at 17-19), the petitioners argue that there should be no subtraction of tax benefits from the damage award because the only subtraction authorized by Section 12(2) is of "income received," and tax benefits are not "income received."[29]

There are two answers to this. First, tax benefits are more properly regarded as a return of, or a reduction in, "considera-

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29 *United Housing* is inapposite. The Court concluded that the purchase of shares in a cooperative housing project constituted the purchase of living space, not a security. The tax benefits that flowed from the purchase did not constitute "profits" within the meaning of the rule defining a security in terms of the expectation of profits from the managerial efforts of others. The Court never reached the question presented here, where tax benefits are the very *raison d'etre* of the investment in a tax shelter. Indeed, the Court noted that "[e]ven if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* at 855 n.20. Here, of course, the opposite is true: the tax benefits arose solely through the respondents' management of Alotel Associates.

The SEC filed an *amicus* brief in *United Housing* urging that the co-op shares be held to be securities. *See* Brief for Securities and Exchange Commission as *Amicus Curiae*, *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). While there is no such issue here, the SEC's reasoning does apply:

> The lure of reductions in taxes and costs—such as those that were promised the investors in the instant case—may be as strong an inducement to invest as the hope of direct monetary gain, and one as likely to mislead an innocent investor. It is immaterial whether the economic inducement is in the form of cash payments or, as here, reduced carrying charges and tax advantages.

Id. at 15-16.

tion paid" than as "income received," since the Government is subsidizing the cost of the investment.[30]

Second, even if the "consideration" view is not accepted, an interpretation of "income received" to mean "value" received, as the Eighth Circuit understood it (*Austin* II, 768 F.2d at 955), is necessary to attain the goal of restoring the *status quo ante*. The term "income received" is nowhere defined in the 1933 or 1934 Acts. Under such circumstances, the term must be read in accordance with the purpose of the provision. *United Housing Foundation, Inc. v. Forman*, 421 U.S. at 849; *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459, 461 (1892). As all parties and the *amici* seem in accord that the purpose of Section 12(2) is rescission and restitution, the result adopted by the Eighth Circuit follows at once. While we believe that the petitioners' tax benefits are more properly characterized as a return or subsidy of "consideration paid," either approach accomplishes the purpose of rescission—a subtraction of the benefits received in the course of the investment.

D. *Interest Was Properly Awarded Only On The Amount The Petitioners Were Out Of Pocket At Any Given Time*

The Eighth Circuit determined that interest should be awarded "only on the amount of money [the petitioners] were out-of-pocket at any given time." *Austin II*, 768 F.2d at 959. The petitioners do not appear to take issue with this under Rule 10b-5, where the award of interest is discretionary. As discussed in II.C.1., *supra*, *in pari materia* considerations

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30 For example, one of the effects of tax deductions taken by the petitioners was a reduction in the basis of their investments, the tax-law analog to consideration paid. Also, at the damages retrial after *Austin I*, the petitioners' expert witness stated that the tax benefits were not income received and the respondents' expert witness testified that both from an accounting and an investing standpoint, the petitioners' tax benefits were properly categorized as a reduction in their capital investment. (J.A. 183-84, 205). This view also finds support in the most recent Treasury Regulations requiring partners' capital accounts to be reduced by various tax deductions. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (1985).

compel the same result under Section 12(2) as under Rule 10b-5.

Under Section 12(2), the petitioners argue that the placement of the word "interest" after "consideration paid" and before "income received" necessitates the conclusion that they are entitled to interest on their entire consideration paid ($157,500) for some twelve years, even though they were barely out of pocket for most of that time.

As an initial matter, if tax benefits are regarded as a reduction of the net amount invested, *i.e.*, a reduction or subsidy of "consideration paid," the petitioners' statutory construction argument against applying interest on the net amount outstanding loses its validity. They have been awarded interest on the amount of "consideration paid" outstanding at any given time.

Even assuming that the petitioners' tax benefits ought to be treated as "income received" rather than as a return of "consideration paid," nothing in Section 12(2) prevents a court from imputing interest on income received, which has the same effect as applying interest only on the net amount out of pocket, where to do so is necessary to return the purchaser to the *status quo ante*. The purpose of an award of prejudgment interest under the securities laws is to compensate plaintiffs for the loss of the use of their money.[31] To the extent they receive some of their money back, there should be less to apply interest to. *See Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); L. Loss, *Fundamentals of Securities Regulation* 1020 (1983) (Section 12(2) damages are "the difference between the purchase price and the plaintiff's resale price, plus interest,

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31 *See Scheve v. Clark*, 596 F. Supp. 592, 596 (E.D. Mo. 1984) (plaintiffs entitled to recover damages under securities laws, including Section 12(2), awarded interest at rate that will adequately compensate them for use of their money); *Cant v. A.G. Becker & Co., Inc.*, 384 F. Supp. 814, 815 (N.D. Ill. 1974) (in securities cases prejudgment interest may be awarded where plaintiff has been denied beneficial use of his funds).

and less any income or return of capital (with interest) that the plaintiff received on the security").

The fact that other provisions of the securities laws have not provided for interest has not prevented courts from awarding interest on equitable grounds when appropriate. For example, an award of interest under both Section 16 and Rule 10b-5 of the 1934 Act is within the discretion of the trial court, even though neither provision mentions interest. Whether interest will be awarded under those provisions is to be determined by considerations of fairness. *See, e.g., Blau v. Lehman*, 368 U.S. 403, 414 (1962) (Section 16(b)); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 637 F.2d 77, 87 (2d Cir. 1980) (Rule 10b-5); *Wessel v. Buhler*, 437 F.2d 279, 284 (9th Cir. 1971) (Rule 10b-5). In the present case, fairness dictates that the damage formula permit the lower courts to impute interest on the value an investor receives. Any other result increases damage awards beyond a plaintiff's actual injury, and thus creates a penalty or forfeiture against the defendants.[32]

III. This Court Should Correct The Eighth Circuit's Plain Error Of Doubling The Petitioners' Entire Recovery

We request that the Court consider an issue not raised by the petition for certiorari, namely, whether the Court of Appeals committed a plain error by doubling the petitioners' entire award, damages and interest. *Austin II*, 768 F.2d at 960-61.[33]

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32 The petitioners rely on *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part and rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), in opposition to this. The *Johns Hopkins* decision analyzed Section 12(2)'s rescission remedy. 297 F. Supp. at 1231. The court did not reject the idea of imputing interest on value received, but said it would not impute interest even if it had discretion to do so, because imputing interest in that case would not restore the *status quo ante*, but would instead "put the buyer in a worse, and the seller in a better, position than the status quo ante." *Id.* That is the opposite of the situation here.

33 Under Rule 34.1(a) of the Rules of the Supreme Court, this Court "[a]t its option, . . . may consider a plain error not among the questions presented but evident from the record and otherwise within its jurisdiction to

The petitioners' total damages with interest were $14,473, calculated as follows:

	Investment	-	*Tax Benefits*	=	*Damages*	+	*Interest*	=	*Recovery*
Randall	$ 35,000	-	$ 36,404	=	$-1,404	+	$ 1,657	=	$ 253
Austin	35,000	-	33,333	=	1,667	+	2,166	=	3,833
Anderson	35,000	-	29,615	=	5,385	+	4,010	=	9,395
Neumann	52,500	-	57,014	=	-4,514	+	5,506	=	992
									$14,473

In order to take the tax consequences of the petitioners' recovery into account, 768 F.2d at 960, the Eighth Circuit assumed that the petitioners would have to pay taxes on their awards at a 50% rate and therefore doubled or "grossed up" the petitioners' recovery, to a total of $28,946. *Id.* at 960-61. The court chose to "adopt Loftsgaarden's method" of considering tax consequences. *Id.* at 960.[34]

Loftsgaarden never urged the court to gross up the interest portion of the petitioners' recovery in order to "net out" to 8% interest after taxes, nor was there any logical reason for the court to do so. The petitioners' award should accordingly be calculated as follows:[35]

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decide." U.S. Sup. Ct. Rule 34.1(a), 28 U.S.C.A. *See Washington v. Davis*, 426 U.S. 229, 238 (1976).

34 The Eighth Circuit stated that Loftgaarden's method "takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to 'net out' their actual damage figure." 768 F.2d at 960.

35 Because there is little in the Record, we cannot quarrel with the Eighth Circuit's use of a 50% marginal income tax rate to gross up the petitioners' award, as opposed to a possible lower rate. In other circumstances, plaintiffs may be able to treat an award as a capital gain, at lower rates, resulting in a smaller gross-up figure.

	Damages	+	*Amount Needed to Gross Up*	+	*Interest*	=	*Total Recovery*
Randall	$-1,404	+	$ 0	+	$1,657	=	$ 253
Austin	1,667	+	1,667	+	2,166	=	5,500
Anderson	5,385	+	5,385	+	4,010	=	14,780
Neumann	-4,514	+	0	+	5,506	=	992
							$21,525

The only reason to gross up the award at all is the assumption that, precisely *because* the petitioners received tax benefits earlier, the damage award will be taxed.[36] It follows that only that portion of the award which is taxed for that reason should be grossed up. Interest is not taxed as a result of earlier tax benefits having been taken, and thus should not be grossed up. This will put the petitioners on an even footing with other investors who, after their net damages are ascertained, receive only simple interest.

IV. Other Points Raised By The Petitioners And The Amici

A. *Alleged Inconsistency With Supreme Court Precedent*

The petitioners argue that the Eighth Circuit's holding in *Austin II* failed to follow this Court's holdings in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968), *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490 (1980), and *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523 (1983). Brief for Petitioners at 25-27.

In *Hanover Shoe*, an antitrust case involving damages for lost profits, this Court held that pre-tax lost profits must be

36 Had the petitioners never received any tax benefits that reduced their basis, the damage award would be a nontaxable return of capital. 1 J. Mertens, *Law of Federal Income Taxation* § 5.06 (J. Doheny rev. ed. 1981) ("When amounts received under a lawsuit . . . represent a loss of profits the amount is taxable income; when all or a part of the amount represents damages for lost capital such amount is not taxable."); *see Mathey v. Commissioner*, 177 F.2d 259, 260-61 (1st Cir. 1949), *cert. denied*, 339 U.S. 943 (1950).

awarded, since the plaintiff's damage award would be taxed when received. 392 U.S. at 503. In *Liepelt* and *Pfeifer*, the Court held that an award for a decedent's lost income should be based on after-tax earnings since wrongful death awards "are not taxable income to the recipient." *Liepelt*, 444 U.S. at 496; *see Pfeifer*, 462 U.S. at 534.

The petitioners argue that these three cases say that tax consequences are not to be considered unless a damage award is non-taxable. This has nothing to do with the treatment of tax benefits *already received*, as here, as opposed to the treatment of tax "consequences" of a recovery so as to prevent windfalls (*Liepelt* and *Pfeifer*) or shortfalls (*Hanover Shoe*) for the plaintiff.

B. ***The Petitioners Will Not Have To Amend Their Returns***

If the petitioners really believed that they "may" have to amend their returns to give back all their tax benefits, Brief for Petitioners at 38-41—a position that the Government does not assert—it is not clear what they hope to have gained by seeking certiorari. The fact is, the petitioners have received permanent tax benefits. *Austin II*, 768 F.2d at 955.

The petitioners' argument is drawn from *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984) ("[U]nder the tax benefit rule, [plaintiffs'] prior tax benefits will be disallowed. Although this court cannot directly disallow the prior tax benefits because plaintiffs' tax liabilities are not directly before us, we presume that the IRS will do its duty if the doctors should actually recover on their judgments and thereafter fail to file amended returns as required by law."), and *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) ("plaintiffs will have to amend their income tax returns to report those funds as income" and thus "[t]he amounts claimed as a deduction and the amounts later reported as income will wash out and the net tax benefit will be nothing"), *aff'd sub nom., Western Federal Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984).

In the first place, *Burgess* and *Western Federal Corp.* were wrong in stating a need to amend prior returns in any event.[37] Under the tax benefit rule, the petitioners would, at worst, merely report the recovery of certain amounts previously deducted as taxable income in the year a money judgment was recovered. *See Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 377-81 (1983). As shown by this very case, that still leaves a very large tax benefit in the petitioners' hands.

Second, the transaction at issue was not, as petitioners claim, void *ab initio*. *Cf. Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970) (pursuant to Section 29(b), contracts made in violation of the 1934 Act are voidable, not void); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03 [c][vi] at 11-60 n.24 (2d ed. 1985). It was only voidable on account of the misrepresentations. 1A A. Corbin, *Corbin on Contracts* § 228 (1963). Under the tax laws, the petitioners would be entitled to tax benefits up until the time they exercised their option to avoid the contract, if that time ever came.

Finally, we agree that if a judgment, *because of earlier tax benefits*, was itself taxable, the judgment should be grossed up to account for that. *See* III., *supra*. However, the Ninth Circuit went far overboard in establishing a fixed rule that such a gross-up would always eliminate tax benefits, when it is clear that the situation can differ widely depending on the nature of the tax shelter, the duration of the tax shelter, and other factors, as shown by the facts now before the Court.

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37 The sole authority cited by the Ninth Circuit, "Mertens *Law of Federal Income Tax*, § 7.37," *Burgess*, 727 F.2d at 838, was read erroneously. It does not stand for the principle asserted. In fact, it stands for the correct principle.

C. *Deterrence Of Disclosure Violations*

The petitioners and the amici argue that application of the Eighth Circuit's decision would discourage needed private enforcement of the antifraud provisions of the securities laws. Brief for Petitioners at 32-36; Brief for Government at 27; Brief for Hon Industries, Inc. at 25-29.

This contention is erroneous for three reasons. First, application of the tax benefit offset rule does not reduce a defrauded investor's actual damages. Rather, the tax benefit offset rule insures that an investor receives his actual damages—only the amount that he has lost. This result is consistent with, not in conflict with, the purpose of Section 12(2) of the 1933 Act and Section 28(a) of the 1934 Act. Carried to its logical conclusion, the private enforcement argument would "encourage" suits in situations where there was no damage under anyone's view, *e.g.*, where there was a full return, as dividends, of all a plaintiff invested.

Second, the legislature, not the judiciary, is the appropriate body to determine whether to encourage the filing of private damage actions.[38] As embodied in Section 12(2) of the 1933

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38 *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975).

In addition to the argument based on the decision in *Alyeska*, in past cases this Court has rejected similar arguments advanced by the SEC to broaden the securities laws and expand litigation in the name of enhanced deterrence. *See, e.g., International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*, 439 U.S. 551, 570 (1979) (rejecting SEC's contention that non-contributory, compulsory pension plans are securities); *Securities and Exchange Commission v. Sloan*, 436 U.S. 103, 115-16 (1978) (rejecting SEC's argument that the remedial purposes of the 1934 Act require successive suspension of trading in particular securities to maintain fair and orderly markets, even assuming that such successive suspensions are necessary to a satisfactory remedy); *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976) (SEC's suggestion that the broad venue provisions of the 1934 Act should govern a securities action against a bank as an aid to enforcement was rejected in part because such policy arguments "are more appropriately addressed to Congress than to this

Act and Section 28(a) of the 1934 Act, Congress has chosen to provide no greater incentive for a potential private plaintiff than the award of his "actual damages."

In *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), the Second Circuit, while acknowledging that punitive damages would deter violations of the Act, pointed out that the securities laws provide many means to punish and deter violators, even absent punitive damages. 418 F.2d at 1284-85. The court thus declined to permit an expanded remedy for punitive damages.

Finally, there are cases where, without a rule taking tax benefits into account, a defrauded investor might have no remedy. *Cf. Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (absence of represented tax benefits one component of fraud), *cert. denied*, 455 U.S. 938 (1982); *Beggs v. Dougherty Overseas, Inc.*, 287 F.2d 80, 83 (2d Cir. 1961) (where parties had income tax benefits in mind when they entered into employment contract, tax benefits that were lost when employee was wrongfully discharged "were properly allowed as elements of damage"). Ignoring tax benefits in such cases would discourage, not encourage, private enforcement.

The balance Congress has established between private deterrence and other deterrence under the securities laws should not be altered except by Congress. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (in denying implication of a private right of action under Section 17(a) of the 1934 Act,

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Court"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976) (rejecting SEC's contention that Rule 10b-5 should encompass both intentional and negligent behavior); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 426 (1972) (rejecting SEC's argument that Section 16 of the 1934 Act applies to all sales within six months by one who has become a ten percent owner by voluntary purchase, regardless of amount of seller's holdings at the time of the sale); *Blau v. Lehman*, 368 U.S. 403, 411-14 (1962) (rejecting SEC's argument that Section 16(b) of the 1934 Act should be interpreted to permit recovery of short-swing profits from partnerships in order to close a loophole in the statutory scheme).

the Court reemphasized "that generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit' ").

D. *"Banking A Fraud"*

The petitioners contend that if their damage award is reduced by the amount of tax benefits they received, the respondents will benefit at the Government's expense and the Government will thereby be banking a fraud. Brief for Petitioners at 36, relying on *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984) ("we decline to make the government the banker for fraudulent tax shelter activity").

The Second Circuit answered this in *Salcer*:

> The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Salcer, 744 F.2d at 941.

What the Government really wants is a large award to the petitioners which it can tax, thus recouping some of the tax benefits it granted. This is simply unjust, and flies in the face of Congressional intent that tax benefits be conferred for the construction of such real estate projects. *See* 26 U.S.C. § 465(c)(3)(D). There was no fraud on the Government here, there was no misrepresentation as to the entitlement to tax benefits, and there were no claims to tax benefits that were not supported by exactly the kind of expenditures the Government wished to bring about. All tax benefits were the subject of Internal Revenue Service audits and were approved.

The Government also complains that the Eighth Circuit's decision results in a transfer of tax benefits to the respondents. But, when the lower courts ordered the respondents to reim-

burse the petitioners for their net economic loss, the respondents became the financiers of the project, or at least of so much of it as the Government had not funded. To the extent those benefits are deemed by the Government, *see* Brief for Government at 21, to be "transferred" to the respondents by subtracting them from the damage award, that is where they now belong.

E. *Different Damage Awards Based On Actual Injury*

The petitioners argue that taking tax benefits into account results in different damage awards for investors in different tax brackets. Brief for Petitioners at 37. This is true, but irrelevant.

The principle works no differently from other tort damage principles that require a defendant to take the plaintiff as he finds him. Prosser & Keeton, *The Law of Torts* § 43 (5th ed. 1984); C. McCormick, *Handbook on the Law of Damages* § 76 (1935); 22 Am. Jur. 2d *Damages* § 122 (1965). A recklessly driven car in a collision with both a luxury car and a compact car leads to more damages for the owner of the former than the latter. That does not make an "actual damages" rule anomalous.

F. *"Speculativeness" Of The Petitioners' Tax Consequences*

The petitioners claim that is is inappropriate for a court in a securities fraud action to consider tax consequences because such consideration would necessarily be premature and speculative. The petitioners argue that there are so many "unknowns" involved that it is "impossible for a trier of fact to make an accurate allocation." Brief for Petitioners at 42. In the first place, these considerations are inapplicable here, where the petitioners' tax status is fixed and unchangeable. More generally, as to speculative evidence, if a party cannot satisfy his burden of proof on an issue he simply will not have a ruling in his favor on it. This is not a reason to prevent him from offering his proof.

In *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 494 (1980), a wrongful death action brought under the Federal Employers' Liability Act, this Court specifically held that evidence as to future tax consequences is neither too speculative nor too complex to be considered and resolved by a jury. *In re Air Crash Disaster*, 701 F.2d 1189, 1192 (7th Cir.), *cert. denied*, 464 U.S. 866 (1983); *Fanetti v. Hellenic Lines Ltd.*, 678 F.2d 424, 431 (2d Cir. 1982), *cert. denied*, 463 U.S. 1206 (1983); *O'Connor v. United States*, 269 F.2d 578, 584 (2d Cir. 1959). Jury consideration of the petitioners' tax benefits is no more uncertain or speculative than many other determinations made by juries. *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. at 494.[39]

The petitioners further argue that having a jury consider the likelihood of an IRS audit of their past tax deductions, as well as the possible results of such an audit, involves more uncertainty and speculation. Moreover, it creates a "dilemma" for the petitioners because "[p]roving the weakness of [their] 'tax shelter benefits' creates a road map for an IRS audit, but failing to offer proof reduces the damages available." Brief for Petitioners at 43. The petitioners do not explain why, if their tax shelter benefits are undeserved, they should not provide this road map. They have declared under penalty of perjury on their tax returns, *see* 26 U.S.C. § 6065, that the tax benefits were warranted; it is not too much to expect that they will take the same position in their lawsuit.

The district courts have substantial expertise in evaluating tax benefits; they do so in tax cases every day. They will not lose their expertise in the midst of a securities case.

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39 Indeed, the trier of fact must often consider and resolve factual issues fraught with future uncertainty. *Sea-Land Serv., Inc. v. Gaudet*, 414 U.S. 573, 588-90 (1974) (allowing decedent longshoreman's dependents to recover damages for loss of support, services and society under federal maritime law, despite objections that such damages are speculative); *Palmer v. Connecticut Ry. Co.*, 311 U.S. 544, 558-62 (1941) (allowing future damages for breach of long-term lease, despite uncertainty as to future rental value of property).

G. *Unjust Enrichment*

While the lower courts found there was no unjust enrichment of the respondents, and the issue was not among the questions presented for certiorari, the petitioners repeatedly assert that the respondents were "unjustly enriched." This is unsupported by the record and is in any event a red herring. The argument is apparently advanced in an effort to take advantage of *Affiliated Ute*, *supra*, where defrauded sellers of stock could recover appreciation in the hands of the buyers lest the buyers be unjustly enriched. Of course, this has nothing to do with anything here.

Second, even if there were unjust enrichment, the petitioners abandoned their claims for it at trial. *See* n.5, *supra*.

Third, even if the petitioners had not dropped their claims, and could prove unjust enrichment, this might increase their damages but would not free them of the offset of tax benefits from the increased award.

Finally, the "facts" the petitioners cite in support of their contention are inaccurate. One source of the petitioners' charges is the statement in the dissenting opinion in *Austin II* that "[t]here was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme." 768 F.2d at 963. Apparently, the dissent relied on the finding of fact in the district court that the Offering Memorandum projected "that the developer and construction company would receive a total of $103,900 for 'overhead and profit.' " (*See* J.A. 118; Pl. Ex. 2; Tr. 42). There was no evidence that these sums were realized.

The petitioners also recite a list of figures representing payments the respondents received from Alotel Associates for services performed. Brief for Petitioners at 4-5, 35. While some of the figures the petitioners cite are incorrect or misleading, as detailed below, it is more important to note that neither the petitioners nor the courts involved in this case have pointed to any evidence that the respondents impermissibly profited

from the financial transactions at issue, or that any fees or commissions received by the respondents were unreasonable or unnecessary.[40]

Turning to the figures listed by the petitioners, it is alleged that 2361 Corp. received $23,524 for "reimbursement." Brief for Petitioners at 4. An examination of the trial exhibits cited by the petitioners reveals no $23,524 sum.

The petitioners also assert that 2361 Corp. received $63,724 for undisclosed purposes. Brief for Petitioners at 4-5. Defendants' exhibit 41g shows that Star Crown Industries Inc. had been employed by 2361 Corp. to provide various fixtures at a cost of $6,296.65. The same exhibit shows that the Singer Company had been employed by 2361 Corp. as the "material supplier of heating units" at a cost of $57,427.84. The sum of the above two figures is $63,724.49.

The petitioners also assert that the Offering Memorandum omitted information about Loftsgaarden's control of Alotel, Incorporated, PDRC, and 2361 Corp. While it is true that the opinion in *Austin I* characterized the district court's finding as one "that Loftsgaarden had omitted any explanation of the role his closely-held corporations would assume in the development," 675 F.2d at 175, the Offering Memorandum did in fact disclose certain information and make certain projections as to the respondents' expected compensation that tend to negate the petitioners' implication that the respondents' anticipated reward for their work was kept secret. For example, as to Loftsgaarden's control of Alotel, Incorporated, the forecasts of Alotel Associates prepared by Touche Ross & Co., which were included in the Offering Memorandum, said that Loftsgaarden would be an officer and majority shareholder of Alotel, Incorporated. (J.A. 120; Pl. Ex. 2; Tr. 42). The Offering Memorandum also revealed that the developers of the

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40 Loftsgaarden testified that he received no profit as the owner of PDRC (Tr. 658-59), or as the owner of 2361 Corp. (Tr. 668), and that the fee charged for the design of the motel, by the architectural firm of which he was a part owner, was not unreasonable (Tr. 669).

project contemplated entering into a construction contract with a construction company:

> owned or controlled by persons who are also in ownership or control of the corporate general partner [Alotel, Incorporated] of the Partnership. It is therefore possible that larger than usual profits could be made by said persons in connection with the construction of the project.

(J.A. 96; Pl. Ex. 2; Tr. 42; *see* J.A. 120; Pl. Ex. 2; Tr. 42). Finally, an examination of the provision of the Offering Memorandum governing compensation of the general partner demonstrates that the general partners' opportunity to profit as manager of the Alotel Associates' property was tied to the success of the enterprise. (*See* J.A. 99; Pl. Ex. 2; Tr. 42).

CONCLUSION

The judgment of the Court of Appeals should be affirmed in all respects except that, insofar as it awarded the petitioners twice the interest on their damages, the judgment should be modified to award only single interest.

Respectfully submitted,

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